

# ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Horton

Analyst: Kristina E. North

Bill Number: AB 654

Related Bills: See Legislative History

Telephone: 845-6978

Amended Date: April 23, 2001

Attorney: Patrick Kusiak

Sponsor: \_\_\_\_\_

**SUBJECT:** Energy Conservation Refundable Credit and Energy Conservation Deduction

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended \_\_\_\_\_.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

X FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_.

REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED  
\_\_\_\_\_ STILL APPLIES.

X OTHER - See comments below.

## SUMMARY

This bill would create:

- ◆ A refundable credit for personal income taxpayers that purchase energy efficient residential appliances; and
- ◆ A deduction for all taxpayers that install energy conservation measures.

These provisions are discussed separately in this analysis.

## SUMMARY OF AMENDMENTS

The April 23, 2001, amendments added the provisions discussed in this analysis.

## PURPOSE OF THE BILL

According to the author's office, the purpose for this bill is to encourage taxpayers to practice energy conservation in their homes and places of business.

Board Position:

<u>      </u> S	<u>      </u> NA	<u>      </u> NP
<u>      </u> SA	<u>      </u> O	<u>      </u> NAR
<u>      </u> N	<u>      </u> OUA	<u>      </u> X PENDING

Department Director

Date

Gerald H. Goldberg

06/05/01

## EFFECTIVE/OPERATIVE DATE

This bill is a tax levy and would be effective immediately upon enactment. The bill's provisions would be operative for taxable years beginning on or after January 1, 2001.

## POSITION

Pending.

### Summary of Suggested Amendments

A substantive amendment requesting an appropriation and a technical amendment correcting a typographical error are provided. Department staff is available to assist with amendments to resolve the other concerns addressed in this analysis.

## ANALYSIS

### FEDERAL/STATE LAWS

**Current federal law** provides two energy-related credits: an energy investment credit, and a business credit for the production of electricity from certain renewable resources.

The energy investment credit is equal to 10% of the basis of energy property placed in service during the taxable year. Energy property includes equipment that uses solar energy to generate electricity, to heat or cool a structure, or to provide solar process heat. The equipment also must meet performance and quality standards prescribed by federal regulations.

The business credit for the production of electricity from certain renewable resources is equal to 1.5 cents multiplied by the kilowatt hours produced by the taxpayer's qualified energy resource and facility. To qualify, the energy must be sold to an unrelated person during the taxable year. Qualified renewable energy resources included wind, closed-loop biomass, and poultry waste.

**Prior federal law** allowed a credit equal to 15%, up to a maximum total credit of \$300, for the purpose and installation of energy-saving components in an individual's residence. The qualifying expenditures included such items as:

- ◆ Energy efficient furnace burners and electrical or mechanical furnace ignition systems; and
- ◆ Storm or thermal windows or doors, and caulking or weather-stripping or exterior doors or windows.

A separate federal credit equal to 40% of the costs, up to a maximum total credit of \$4,000, was allowed for tax years 1979 through 1986. That credit was based on the purchase and installation of renewable energy equipment, such as solar energy systems, and wind and geothermal energy equipment. It was required that the renewable energy equipment be installed in an individual's primary residence located in the United States. The equipment must have been new when installed and have had an expected useful life of at least five years.

**Prior state law** allowed two energy related credits: an energy conservation credit equal to a percentage of the cost of energy measures; and a solar energy credit also equal to a percentage of the cost of the solar energy system.

**Current state law** does not provide a related credit or deduction.

**Current state and federal laws** generally allow taxpayers engaged in a trade or business to deduct all expenses that are considered ordinary and necessary in conducting that trade or business. However, expenses for purchasing property with a useful life in excess of a year, or purchases that add to the value or substantially extend the useful life of property owned by the taxpayer, must be capitalized and depreciated over the recovery period of the property rather than deducted in the year purchased.

### THIS BILL

#### ***REFUNDABLE ENERGY EFFICIENT RESIDENTIAL APPLIANCE REPLACEMENT CREDIT***

Under the Personal Income Tax Law (PITL), **this bill** would allow a credit equal to 25%, up to \$500, for the purchase of energy efficient residential appliances as replacements for existing appliances.

This bill would define:

- ◆ “Appliances” as including refrigerators, washing machines, clothes dryers, hot water heaters, microwave ovens, convection ovens, dishwashers, space heaters, and portable air-conditioning systems.
- ◆ “Energy efficient” as any appliance certified to meet the applicable *ENERGY STAR* efficiency requirements developed by the U.S. Environmental Protection Agency and the U.S. Department of Energy.

As a condition of claiming this credit, the taxpayer must obtain a signed statement from a particular business representative verifying that the replaced appliance was disposed of properly.

Any credit amount that exceeds the taxpayer’s tax liability would be refunded to the taxpayer upon appropriation by the Legislature.

### IMPLEMENTATION CONSIDERATIONS

A definition for the term “residential” is necessary as energy efficient “residential” appliances may be capable of being used in structures other than dwellings. Undefined terms may complicate implementation and administration of this credit.

A significant number of California residents are not required to file a California income tax return due to their income levels. These individuals may file a tax return to obtain the refundable credit, thereby increasing the number of returns received by the department.

This bill would require regular appropriations by the Legislature to pay for the refundable portion of this credit. If sufficient funds were not appropriated to cover all of the refunds due, the department would suspend payment of the refunds until additional funds were appropriated. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

Since the proposed credit is refundable, the credit would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540 2EZ. This would increase PIT return Forms 540, 540NR, 540X, and potentially the Form 540A by one page. Adding a page to these forms would result in a significant impact on Franchise Tax Board's operations and costs, would slow return processing, and would increase the amount of return storage space. The department may be required to lease additional office and file storage space; however, the department would work within available space to the extent possible.

Additional resources would be necessary to prevent the fraudulent filing of returns for the purpose of claiming the refundable credit.

#### TECHNICAL CONSIDERATIONS

Amendment 1 is provided to correct a typographical error.

#### POLICY CONCERNS

The credit provision in this bill does not specify a repeal date. Credits typically are enacted with a repeal date to allow the Legislature to review the effectiveness of the credit.

Historically, refundable credits such as the prior state renter's credit and the federal Earned Income Credit have had significant problems with invalid and fraudulent returns. These problems are aggravated if a refund made to a taxpayer is later determined to be fraudulent. The refund commonly cannot be recovered.

This credit would allow non-corporate landlords to claim the credit for a rental unit in which an energy efficient residential appliance was purchased as a replacement for an existing appliance. This credit is not provided in the Bank and Corporation Tax Law (B&CTL), thus it would not be extended to corporate landlords.

This credit does not require the new appliance to be installed/used in California.

This bill would not allow a credit to a taxpayer that voluntarily installs energy conservation measures that are not in response to recommendations made by a utility company or energy conservation rater.

#### ***ENERGY CONSERVATION DEDUCTION***

Under the PITL and the B&CTL, **this bill** would allow a deduction of up to \$5,000 for the installation of energy conservation measures in a taxpayer's residence or place of business.

Under the PITL, the deduction must be computed by reducing the maximum allowable deduction by the dollar amount determined by multiplying the taxpayer's adjusted gross income (AGI) by 2%. Under the B&CTL, this computation would be done using the taxpayer's net income rather than AGI.

This bill would define "installed" and "energy conservation measures." The PITL definition for "energy conservation measures," would include whole house fans but the B&CTL definition does not. The deduction must be claimed for the taxable year in which the energy conservation measure is fully installed, i.e., in a functionally operative state. The deduction may include costs in any prior taxable year related to the installation of the energy conservation measure.

Any credit or depreciation otherwise allowed for costs paid or incurred for which this deduction is allowed must be reduced by the amount of the deduction.

### IMPLEMENTATION CONSIDERATIONS

It would be helpful if the bill could provide an example of an "Energy Management System to reduce peak lighting and HVAC loads." Additionally, it would be helpful if the acronym HVAC could be spelled out.

Under the PITL, this bill would require the deduction to be reduced by 2% of California AGI. Individuals who itemize deductions are already reducing certain expenses by 7.5% or 2% of federal AGI. This bill would add a third calculation, complicating the preparation of the income tax return.

Currently, a business can deduct the full amount of many of the smaller items specified as part of this deduction. This bill would prevent any further deduction of the full amount of these smaller items (such as ceiling, wall, and floor insulation, weather-stripping of doors and windows, external hot water insulation or blankets, etc.) under the general business expense deduction by specifically including them in this deduction.

Instead, the taxpayer would receive only a percentage of what could otherwise be claimed. Thus, this bill may not be as beneficial to businesses as the current general business expense deduction for claiming the smaller items listed under the energy conservation measures definition.

In addition, the bill is unclear regarding the manner by which "depreciation otherwise allowed" is to be reduced by the amount of the deduction allowed by the bill. One interpretation would reduce the basis subject to depreciation by the amount of the deduction. Another would reduce an otherwise allowable depreciation deduction by the amount of the deduction allowed by the bill.

The term "place of business" is not defined and is open for interpretation. For example, a lessee at a mall may be encouraged to make repairs on the location he or she is leasing and claim expenses the landlord would normally incur and claim.

### POLICY CONCERNS

This bill would only allow a deduction to a taxpayer that installs energy conservation measures in response to recommendations made by a utility company or energy conservation rater. This bill would not allow a deduction that to a taxpayer that voluntarily installs energy conservation measures. This treatment may be viewed as inequitable.

This bill does not limit the deduction for the installation of conservation measures to installations made in California.

## LEGISLATIVE HISTORY

**ABX 133** (Horton, 2001/2002) and **ABXX 25** (Horton, 2001/2002) are nearly identical to this bill. **ABX 133** died at the Assembly Desk. **ABXX 25** is in the Assembly Housing and Community Development Committee.

**SB 654** (Haynes, 2001/2002), **SBX 54** (Haynes, 2001/2002) and **SBXX 54** (Haynes, 2001/2002) would allow a refundable credit for energy conservation. **SB 654** and **SBX 54** failed passage from the Senate Energy, Utilities and Communications Committee. **SBXX 54** is in the Senate Energy, Utilities and Communications Committee.

**ABX 27** and **AB 1124** (Koretz, 2001/2002) would allow multiple credits and an accelerated depreciation deduction for the purchase of a power generation system. **ABX 27** failed passage from the Assembly Appropriations Committee, and **AB 1124** failed passage from the Assembly Utilities and Commerce Committee.

**ABX 15** (Rod Pacheco, 2001/2002) would allow a 100% credit for the purchase of energy conservation measures that reduce a taxpayer's electricity and natural gas use by 5% from the previous taxable year. This bill is in the Assembly Revenue and Taxation Committee.

**ABX 86** and **AB 1264** (Campbell, 2001/2002) would allow a 75% credit for the purchase and installation of a solar energy system for residential purposes. **AB 86** is from the Assembly Revenue and Taxation Committee without further action. and **AB 1264** is in the Assembly Revenue and Taxation Committee.

**SBX 17** (Brulte, 2001/2002) would allow a credit for the purchase and installation of a solar energy system for the production of electricity. This bill is from Assembly without further action. **SBXX 17** is in the Assembly Revenue and Taxation Committee.

**AB 873** (Takasugi, 1997/1998) would have allowed a credit equal to 40% of the cost of energy conservation measures. The bill also would have allowed a second credit equal to 10% of the cost of a solar energy system installed on premises located in California and used for commercial purposes, subject to certain requirements. The bill failed to pass the Assembly Revenue and Taxation Committee.

## OTHER STATES' INFORMATION

*Florida* exempts from sales and use taxes certain energy-related activities, such as the manufacture of, or the machinery or equipment used to produce electrical or steam energy. Solar energy systems and components of solar energy systems are tax-exempt through June 30, 2002.

*Massachusetts* currently has an energy credit that is equal to 15% of the net expenditures or \$1,000, whichever is less. However, Massachusetts does not allow an energy-related deduction, but exempts a limited portion of local property tax for certain alternative energy systems, such as solar or wind powered systems or hydropower facilities built after 1978.

*Michigan* does not allow an energy-related credit or deduction, but exempts the value of energy conservation devices from the local property tax.

*New York* allows, for personal income taxpayers only, a credit for solar generating equipment equal to 25% of certain solar generating expenditures. The credit is capped at \$3,700 per system. *New York* also exempts from property tax for 15 years any increase in assessed value of real property due to the value of a solar or wind energy system approved by the New York State Energy Research and Development Authority.

*Oregon* currently has two energy credits: a PIT consumer energy purchases credit and a corporate tax credit for the costs of energy projects. The consumer energy purchases credit allows various credits ranging from \$50 to \$1,500 for consumer purchases of certain items. The corporate credit for the costs of energy projects is a credit equal to 35% of the incremental costs of the project involving energy conservation and other related projects.

*Texas* does not allow an energy-related credit or deduction, but exempts from sales or use tax the repair, remodeling, maintenance, or restoration services on intangible personal property used to conserve energy.

## **FISCAL IMPACT**

Departmental costs to implement the new refundable credit portion of this bill are estimated to be \$5.5 million for initial implementation, with continuing annual costs of \$4.3 million. These costs are based on a projected universe of 2 million new filers and 14 million current filers claiming the credit.

Amendment 2 is provided to request an appropriation for these increased costs.

## **ECONOMIC IMPACT**

### Tax Revenue Estimate

Based on data and assumptions discussed below, the provisions in this bill would have the following order of magnitude revenue losses.

Estimated Revenue Impact of AB 654 Annual Order of Magnitude As Amended 4/23/01 [\$ In Millions]	
	2001/2002 and Ongoing
Refundable Tax Credit	-\$75
Deduction	-\$12

For the refundable tax credit, the estimate assumes an appropriation by the Legislature. The bill would be effective with taxable years beginning on and after January 1, 2001.

### Tax Revenue Discussion

For the proposed refundable tax credit of 25%, the revenue impact would be determined by costs incurred for qualifying residential appliances and the amount of credits generated by taxpayers. This estimate assumes that the Legislature will make an appropriation in the amount necessary to provide refunds to taxpayers.

There are roughly 12.2 million residential structures/units in California. Examples of specified energy efficient residential appliances can range in cost from a low of \$40-\$50 for a portable space heater up to \$1,000 or more for a refrigerator. If one in 20 taxpayers who own or occupy the approximately 12 million residential structures/units incur qualifying costs of \$500, on average, credits generated would total \$75 million.

For the proposed deduction, the revenue impact would be determined by costs incurred for installing energy conservation measures by taxpayers and the adjusted gross income or net income of each of these same taxpayers. The proposed deduction is reduced by 2% of adjusted gross income under the PITL and 2% of net income under the B&CTL. Potential deductions are eliminated once adjusted gross income or net income is \$250,000 or more.

In addition to the 12.2 million residential structures/units, there are over a million business enterprises in California. Specified energy conservation measures and costs that may be claimed as deductions by taxpayers can range in cost from a few dollars for weather stripping to several thousand dollars for a new energy-efficient central heating and air conditioning system in a home to hundreds of thousands of dollars or more by a business in a commercial facility. In any given year, if 1% of households and 5% of businesses incur average costs of \$2,500 and \$5,000 respectively, the potential state revenue loss would be \$10 million for households and \$2 million for businesses assuming an 8% tax rate and allowing for current law business deductions.

#### **LEGISLATIVE STAFF CONTACT**

Kristina E. North  
Franchise Tax Board  
845-6978

Brian Putler  
Franchise Tax Board  
845-6333



Analyst	Kristina E. North
Telephone #	845-6978
Attorney	Patrick Kusiak

FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 654  
As Amended April 23, 2001

**AMENDMENT 1**

On page 2, line 21, delete "Unites States" and insert:

United States

**AMENDMENT 2**

On page 5, line 24, following "SEC. 5" insert:

(a) There is hereby appropriated from the General Fund for expenditure in the 2001-2002 fiscal year the sum of five million five hundred thousand dollars (\$5,500,000) for allocation to the Franchise Tax Board in augmentation of Item 1730-001-0001 of the Budget Act of 2001.

(b) Any funds that are allocated pursuant to subdivision (a) shall be expended by the Franchise Tax Board solely for the purposes of implementation and administration of the Refundable Energy Conservation Credit under Section 17052.88 of the Revenue and Taxation Code.

SEC. 6